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SUBJECT: EUROPEAN COMMISSION GIVES CYPRUS GREEN LIGHT TO ADOPT EURO;
SUBJECT TO COUNCIL APPROVAL

REF: (A) NICOSIA 247, (B) NICOSIA 144, (C) 06 NICOSIA 2033

(U) This cable is sensitive but unclassified. Please treat accordingly.

¶1. (SBU) Summary. On May 16, the European Commission released a report confirming that Cyprus, along with Malta, meets the EU convergence criteria and recommended that Cyprus (and Malta) be allowed to adopt the Euro on January 1, 2008. Also on May 16, the European Central Bank released its own positive report on Cyprus. The Commission's recommendation will be discussed at the June 4-5 ECOFIN meeting and is expected to be approved at the June 21-22 European Council (EU Summit) meeting. The July 10 ECOFIN meeting is expected to establish the final exchange rate at which the Cyprus pound will be converted to the Euro and to formally invite Cyprus (and Malta) to join the Eurozone.

¶2. (SBU) Veiled hints that Germany or other EU Member States might seek to link Euro adoption with progress on the Cyprus issue has increased anxiety in Nicosia. This would be a significant departure with previous EU practice and is regarded as improbable. Nevertheless, the GoC is likely to be on its best behavior in Europe over the next few weeks. Both to beat back this linkage and the Commission's draft "Direct Trade" regulation, the GoC plans next week to formally announce new unilateral measures designed to help foster economic growth in the Turkish Cypriot community. End Summary.

Commission Gives Green Light; Waiting Council Approval

¶3. (U) On May 16, the EU's College of Commissioners approved Economic and Monetary Affairs Commissioner Joaquin Almunia's recommendation that both Cyprus and Malta have achieved "a high degree of sustainable convergence" with the Maastricht criteria and should be accepted into the Eurozone at the beginning of 2008. On the same day, the European Central Bank (ECB) issued its own favorable report.

¶4. (U) While Cyprus has cleared a major hurdle, several smaller hurdles remain. According to the European Commission's website, the Commission's recommendation and the ECB's favorable report will be discussed at the June 4-5 meeting of EU Member State Finance Ministers (ECOFIN). EU heads of state will also discuss the recommendation at the June 21-22 European Council (EU summit).

However, the formal decision whether to invite Cyprus and Malta to join the Eurozone will not be taken until the July 10 ECOFIN meeting. In June, the European Commission, after consultations with the ECB, will also recommend for approval at the July 10 ECOFIN meeting the rate at which the Cypriot pound will be converted into the Euro. While the final decision on whether Cyprus should join the Euro is subject to qualified majority, the final exchange rate must be established by consensus. New Central Bank head Orphanides told the Ambassador May 17 that he did not expect the Commission and ECB to recommend any significant deviation from the current exchange rate, which was just slightly about the parity at which Cyprus entered ERM II.

15. (SBU) Speaking to reporters in Brussels after the May 16 decision, Almunia said, "Cyprus and Malta will become new members of the Eurozone on January 1, 2008. There is no doubt about it, as far as I am concerned." Almunia noted, however, that while Malta was doing very well, the Cypriot "authorities should strengthen preparatory work and I hope they will work hard in the next few months." This language was also repeated in the Commission press release. Orphanides admitted to the Ambassador that he was not sure to what all Almunia was referring, but was taking Almunia's statement very seriously. In any case, he had already intensified the bank's work on harmonizing payment systems and statistics. DG ECFIN-G Acting Director Juergen Kroeger, who was visiting Cyprus, later clarified to the local press that Almunia was referring only to Cyprus's public information campaign and not to the technical details of the national changeover plan, adding that much had already been achieved in the financial sector.

Public Skepticism of Euro Remains High

16. (U) The public information campaign on the Euro only began in earnest about two months ago, but is now in full swing.

Nevertheless, the public remains skeptical. A recent poll reflected that 54 percent of the public felt fear and anxiety about the coming of the Euro, versus 31 percent who expressed optimism and hope.

17. (SBU) The weak support for the Euro is attributed to four factors: (a) the widespread perception that Greece's adoption of the Euro led to significant price increases; (b) the relatively late start of the public information campaign, which was delayed by several months due to a dispute over tendering procedures; (c) Cypriots' natural conservatism and fear of the unknown; and (d) the electioneering tactics adopted by the communist party AKEL -- the largest party in both Cyprus and the governing coalition -- which has advocated postponing adoption of the Euro until 2009, arguing that the fiscal discipline required for entry in 2008 means reduced social spending.

18. (SBU) On May 17, President Papadopoulos thanked the powerful Cypriot unions for allowing the fiscal and wage discipline that was crucial to Cyprus meeting the Euro criteria. He stressed that the Euro and social welfare are not incompatible, and as thanks for their patience, announced plans to launch new social welfare programs in the near future -- a step that may very well signal the de facto start of his presidential campaign.

19. (U) Contacts at the Central Bank believe that the public opinion tide against the Euro has now been reversed. Kroeger noted in his comments to the press that the latest Euro Barometer poll which will be released later this week shows some progress.

GoC worried About Possible Linkage of Euro to Cyprus Issue

110. (SBU) Cryptic comments by Michael Leigh, Director General for DG Enlargement and, more recently, by Germany's Finance Minister Peer Steinbrueck have led to concerns in the GoC that some in the EU may try to link Cyprus's adoption of the Euro to progress on the Cyprus issue, despite strong and persistent denials. Almunia himself rejected this possibility in public remarks on May 16 and most observers believe that the EU is unlikely to allow political considerations to creep into what has previously been exclusively a technical process. Nevertheless, working level contacts at the Central Bank have told us they are convinced that at least some within DG Enlargement have been advocating such a linkage, and the GoC appears not to be taking this threat lying down. For instance,

the GoC has already announced plans to release in the near future a series of unilateral programs designed to help foster economic growth in the Turkish Cypriot community, a move also consistent with its efforts to prevent EU adoption of a "direct trade" agreement with the north.

Need for 80 Million Euro Notes and 545 Million Coins

¶11. (U) The Central Bank of Cyprus estimates it will need 80 million Euro notes of various denominations. Additionally, a total of 545 million new Euro coins will have to be minted, bearing Cypriot national motifs. These coins will have to be minted after ECOFIN's formal decision and are expected to arrive in Cyprus in the Fall of ¶2007. The cost of securing the Euro notes and coins is estimated at CYP 15 million (USD 34.5 million) and will be shouldered by the Central Bank of Cyprus. Commercial banks in Cyprus are scheduled to receive their stocks of Euro coins in October 2007 and of Euro notes in November 2007. The banks will then have to supply merchants with Euros in the period leading up to January 1, 2008.

Comment

¶12. (SBU) With the Commission's recommendation and the positive ECB report, Cyprus has cleared a major hurdle on its path toward adopting the Euro. While the European Commission was very critical of the technical aspects of Cyprus's preparations in its December 2006 convergence report, Cyprus appears to have made significant progress in this regard. Cyprus still has a long way to go, however, to overcome the public fears that link Euro adoption to significant price rises. With Presidential elections in February 2008, President Papadopoulos has a lot riding on a smooth transition. With the experiences of those who have gone before them, a relatively small population, presidential interest, and a sophisticated financial sector, the Cypriot authorities should be able to deliver.

¶13. (SBU) Comment continued: While it is unlikely that the EU would introduce political considerations into what has heretofore been a purely technical process, the GoC appears convinced that some in Europe have seriously been considering linking Euro adoption to the Cyprus issue. With unanimity needed to establish the rate at which the Cypriot pound will be converted into Euro, it would only take one current member of the Eurozone to effectively block Cyprus's entry. Thus the GoC is likely to be on its best behavior in Europe over the next few weeks. Such a move would be consistent with its "charm offensive" of recent months, which has succeeded somewhat in changing the perception that it is the Greek Cypriots who are the Cyprus problem's intransigent party.

SCHLICHER